(b)

Section 285.305

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

June 19, 1998

Re: 97-0351

Dear Sir/Madam:

Enclosed is a certified copy of the Amendatory Order entered by this Commission.

Sincerely,

Donna M. Caton

Donna M. Caton
Chief Clerk

Enc.

527 East Capitol Avenue, P.O. Box 19280, Springfield, Illinois 62794-9280

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

CONSUMERS ILLINOIS WATER COMPANY	:	
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June 17, 1998

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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AMENDED ORDER

By the Commission:

On July 11, 1997, Consumers Illinois Water Company (the "Company" or "CIWC") filed revised tariff sheets in which it proposed a general increase in water and sewer rates to become effective August 25, 1997. The Company proposed increases in water rates for the Vermilion County, Kankakee, University Park and Oak Run Divisions, and an increase in sewer rates for the Woodhaven Division. The tariff sheets are identified as follows: Original Title Page and Original Sheet Nos. 1 through 12, inclusive, of the Schedule of Rates for the Vermilion County Division (Ill. C.C. No. 31); First Revised Sheet No. 22 of the Rules, Regulations and Conditions of Service for the Vermilion County Division (Ill. C.C. No. 10); Third Revised Title Page, Third Revised Sheet Nos. 1 and 2, Fifth Revised Sheet No. 3, Third Revised Sheet Nos. 4 and 5 and Original Sheet Nos. 11 through 13 of the Schedule of Rates for the Kankakee Division (Ill. C.C. No. 5); First Revised Title Page, Fourth Revised Sheet No. 1, Third Revised Sheet Nos. 2 and 3, Second Revised Sheet No. 4, Fifth Revised Sheet No. 6 and Original Sheet Nos. 7 and 8 of the Schedule of Rates for the University Park-Water Division (Ill. C.C. No. 3); First Revised Sheet No. 6 of the Rules, Regulations and Conditions of Service for the University Park-Water Division (Ill. C.C. No. 4); First Revised Title Page, Third Revised Sheet Nos. 1 and 3 of the Schedule of Rates for the Oak Run Division (Ill. C.C. No. 24); First Revised Sheet No. 11 of the Rules, Regulations and Conditions of Service for the Oak Run Division (Ill. C.C. No. 24); and First Revised Title Page, Third Revised Sheets Nos. 1 and 3 of the Schedule of Rates for the Woodhaven-Sewer Division (Ill. C.C. No. 42).

On July 30, 1997, the Commission suspended the proposed rates to and including December 7, 1997. On December 3, 1997, the Commission resuspended the rates to and including June 7, 1998. Petitions to intervene and/or appearances were filed on behalf of Devro-Teepak, Inc. ("Teepak"), the City of Danville ("City" or "Danville"), the Village of University Park, and the Woodhaven Association, which were granted by the Hearing Examiners.

In accordance with 83 Ill. Adm. Code 255, notice of the filing was posted in the Company's business offices and published in newspapers of general circulation in the areas affected by the filing. Notice of the proposed rate increase also was sent to each affected customer with the first billing after the rate filing in accordance with Section 9-201 of the Public Utilities Act (220 ILCS 5/9-201).

Pursuant to notice, prehearing conferences were held in this matter before duly authorized Hearing Examiners at the Commission's offices in Chicago, Illinois on September 11, 1997 and January 6, 1998. Evidentiary hearings were held in this matter on February 3, 4, and 5, 1998. At the hearings, the Company, Teepak, Danville and the Commission Staff ("Staff") appeared and were represented by counsel. At the hearings, the Company presented the testimony of seven witnesses: Craig M. Cummings; James R. Maurer; Daniel Oliver; Stefan R. Saller; Gary L. Seehawer; Dr. Charles Phillips; and John F. Guastella, Sr. The Staff presented the testimony of six witnesses: Steven R. Knepler; K. Allen Griffy; David P. Fullington; Alan S. Pregozen; William R. Johnson; and Terrie L. McDonald. The City presented the testimony of Ralph Smith. Teepak presented the testimony of four witnesses: Maurice Brubaker; Douglas K. Cunningham; Buranapong Linwong; and Mark Niedenthal. At the conclusion of the hearing on February 5, 1998, the record was marked "Heard and Taken."

Public forums were held at University Park on December 2, 1997; Kankakee on December 4, 1997; Danville on December 8, 1997; and Dalinda on December 16, 1997.

All the parties filed briefs and/or reply briefs except University Park. A copy of the Hearing Examiners' Proposed Order ("Proposed Order") was duly served on the parties. Briefs and reply briefs were filed by CIWC, Staff and Danville. Exceptions and Replies to Exceptions were filed by CIWC and Staff. Danville filed a Brief on Exceptions. The exceptions will be discussed, where appropriate, throughout the Order.

On June 3, 1998, the Commission entered an Order herein granting CIWC increases in water and sewer rates. Section VI of said Order, Rate of Return, however, failed to contain all of the proposed language changes made by the Commission. Accordingly, this Amended Order is needed to reflect those changes.

I. SERVICE AREAS AND NATURE OF OPERATIONS

The Kankakee Division provides residential, commercial and industrial water service to a metropolitan area including the City of Kankakee, the Villages of Bradley, Bourbonnais and Aroma Park, the Shapiro State Hospital, the Illinois Diversatech Campus, Illinois Veterans' Hospital east of Manteno, and unincorporated areas in the vicinity of these municipalities in Kankakee County. The population served by the Division is approximately 64,000.

The Vermilion County Division provides residential, commercial, industrial and municipal water service, including fire protection, to customers located in the City of Danville, Village of Tilton and surrounding areas in Vermilion County. The Division provides wholesale service to the Villages of Catlin and Westville. The Division serves a population of approximately 55,000.

The University Park-Water Division serves a population of approximately 6,800 in the Village of University Park and surrounding areas in Will County. The water service area is divided and served by two separate water distribution, production and storage systems. One system serves a predominantly residential population in the eastern portion of the service area, and the other serves a predominantly industrial area in the western portion of the service area.

The Oak Run Division is located in Knox County approximately 10 miles from the City of Galesburg, and serves approximately 2,500 residential water customers. Water service is available to all lots, and metered service is provided to all permanent structures.

The Woodhaven-Sewer Division is located in Lee County. The Woodhaven Lake Development consists of approximately 6,150 camping lots and 38 commercial lots. The lots are for camping only as no permanent homes are allowed. Sewer service is available to approximately 5,300 lots.

II. OVERVIEW OF THE PROPOSED RATE INCREASE

The rates filed at the outset of this proceeding were designed to produce an overall increase in annual revenues for the five Divisions of approximately $2,854,179. By Division, the increases were as follows: Vermilion County, $1,324,899; Kankakee, $1,152,065; University Park-Water, $133,599; Oak Run, $80,631; Woodhaven-Sewer, $162,985. During the course of the proceeding, the Company accepted certain adjustments proposed by Staff and Danville to test year expenses and rate base. The Company also made an adjustment to revenues at present rates to reflect new Kankakee Division rates which became effective on November 20, 1997, pursuant to the Commission's Order on Remand in Dockets 95-0307 and 95-0342 (Consolidated). As a result, the CIWC proposes that the Commission approve rates in this case designed to produce increases in annual revenues for each of the Divisions, as follows:

Vermilion County	$ 1,333,799
Kankakee	848,002
University Park-Water	128,355
Oak Run	80,237
Woodhaven-Sewer	152,567
TOTAL	$ 2,542,960

The Company maintains that approval of these increases is essential. In recent years, CIWC has experienced declining sales, due to losses of industrial customers, as well as other factors. In the Kankakee Division alone, for example, annual industrial sales have declined by $191,000, or 15%, from the level reflected in that Division's last rate order, Docket 95-0342. In the Vermilion County Division, the General Motors Foundry closed in October, 1996, resulting in an annual revenue loss of $365,000. In University Park, NutraSweet ceased operations in July 1996, resulting in an annual revenue loss of $65,000. CIWC notes that, while sales and revenues have declined, each Division's operating expenses have continued to increase. Rate base also has continued to increase, due primarily to investment in plant additions and improvements which are necessary to permit the Company to continue to provide reliable and safe water service. The Company points out that many of these additions and improvements have been required to comply with increasingly stringent Safe Drinking Water Act regulations.

The Company indicates that the effect of this situation on its financial condition has been devastating. During the period 1994 to 1996, its return on common equity fell from 11.50% to 5.60%, while its pre-tax interest coverage declined from 2.20x to 1.85x. At those levels, the Company indicates that it cannot attract the long-term debt and common equity necessary to finance plant additions on reasonable terms. The Company maintains that its pre-tax interest coverage ratio should be in a range of 2.25x to 3.75x to permit the attraction of long-term debt on reasonable terms. CIWC indicates that the proposed rate increases will produce a pre-tax interest coverage ratio of 3.23x on a pro forma basis.

III. TEST YEAR

In this proceeding, CIWC selected an historical test year ended December 31, 1996, adjusted for changes which either occurred during that year or are reasonably certain to occur through June 30, 1998. No party objected to the proposed test year, and the Commission concludes that the test year selected by the Company is appropriate for use in this proceeding.

IV. RATE BASE

A. Introduction

During the course of the proceeding, Staff and Danville proposed a number of adjustments to the Company's proposed rate base. CIWC accepted certain of these adjustments. In addition, Staff modified certain of its proposed adjustments. As a result, the following rate base items are uncontested:

1) The method of calculating cash working capital.
2) The materials and supplies allowance.

3) The unamortized deferred charges.
4) The customer advances allowance.

Both Staff and Danville have proposed various adjustments to rate base relating to plant in service and other items. As a result, the remaining contested issues affecting the calculation of rate base are hereinafter discussed and include: (1) Staff's proposal to exclude portions of CIWC's adjustment for plant additions in the Vermilion County and Oak Run Divisions; and (2) Danville's proposals for adjusting the Vermilion County Division's rate base to reflect (i) deductions for Accrued Real Estate Tax Expense and FAS 106 accruals; and (ii) elimination of the Company's adjustment for accrued Alternative Minimum Taxes ("AMT").

The Commission has been very through in its consideration of the position of the parties concerning the disputed rate base adjustments. The conclusions reached by the Commission on these matters are a result of its careful review of the entire record, including the exceptions filed by the parties. Since the exceptions have already been considered, no changes to the Order are needed.

B. Plant Additions

1. Background

In this proceeding, the Company proposed that the December 31, 1996 plant-in-service balance for each of the five Divisions (along with all related rate base components) be adjusted to reflect changes reasonably certain to occur prior to June 30, 1998. CIWC subsequently submitted an update of the proposed plant-in-service adjustment which limited the level of plant additions for each Division to amounts which were already "committed" as of November 21, 1997. As Mr. Cummings explained, the "committed" amount includes only funds which, as of November 21, 1997, either were already expended or the subject of then-established contracts, work orders or capital authorizations.

For three of the Company's Divisions, Kankakee, University Park and Woodhaven-Sewer, there is no dispute with regard to the appropriate level of plant-in-service additions. For these Divisions, the Staff indicated its agreement with the levels of plant-in-service additions proposed by the Company. These levels of plant additions are reflected in the rate bases developed for the three Divisions by both the Company and Staff. For the Vermilion County and Oak Run Divisions, however, portions of the plant additions CWIC adjustments proposed remain in dispute.

For Vermilion County and Oak Run, the Company proposed that plant additions in the amounts of $3,965,347 and $75,319, respectively, be reflected in rate base. As Mr. Cummings indicated, ". . . there is no question that these projects will be in-service by June 30, 1998 for the Vermilion County Division." Mr. Seehawer confirmed for the Oak Run Division that the "committed" plant-in-service balance would be placed in-

service prior to June 30, 1998. For these Divisions, Staff proposes to reflect plant additions in the amounts of $3,542,222 and $66,902, respectively. Accordingly, the amounts of Staff's proposed reductions to the level of plant additions are $423,125 for Vermilion County and $8,237 for Oak Run.

2. Position of the Company

The Company disputes Mr. Griffy's proposed adjustments which consist of two components. The first, for the Vermilion County Division, relates to the purchase from the City of a water storage tank and related main. His proposed disallowance of this project accounts for $287,000 of his proposed disallowance of $423,125 for the Vermilion County Division. The remaining $136,125 of Mr. Griffy's proposed adjustment for Vermilion County and his proposed $8,237 adjustment for Oak Run will be separately addressed.

At the time of the scheduled update in this proceeding, the Company presented evidence with regard to the purchase by the Company from the City of a 500,000 gallon elevated storage tank and a related water main. The evidence explained the purchase and indicated that a letter of intent with regard to the purchase had been signed. The evidence submitted by CIWC prior to the time of Mr. Griffy's review in January 1998 showed that the cost of this project is $287,000 ($222,000 for the water tank and $65,000 for the related main). Also, prior to Mr. Griffy's review, CIWC provided him with a copy of the unsigned purchase contract for the water tank and main, and presented evidence indicating that execution of the contract was expected a few days later on January 20, 1998. Finally, at the hearing in this matter, the Company presented the final signed contract, along with City Ordinance No. 7932 enacted on January 20, 1998 which authorized execution of the contract.

The Company submits that, even apart from the signed contract, other evidence regarding the water tank purchase (all of which was in Staff's possession prior to its January review) confirms that purchase of the water tank is reasonably certain to occur. CIWC submits that this evidence (and the signed purchase contract) amply demonstrates a reasonable certainty that the purchase will take place.

Mr. Griffy also proposes to disallow other projects in the Vermilion County Division in the amount of $136,125 and projects in the Oak Run Division in the amount of $8,237. Mr. Cummings explained that the Company's planned construction consists only of projects which, in the opinion of management, are required to maintain quality service and/or comply with applicable regulations. Accordingly, Mr. Cummings indicated that there is a high correlation between planned construction and actual construction completion. CIWC has provided evidence which shows, for the years 1994 to 1996, actual construction expenditures were at 124% of the initially planned levels due to the Company's careful analysis and multiple-step process in determining approval for the construction of additions.

The Company cites the Commission's rules and well-established practices in support of its position. Mr. Cummings argued that the Commission's Adjustment Rule (83 Ill. Adm. Code 285.150(e)) indicates expressly that a utility may propose adjustments for significant changes reasonably certain to occur within 12 months of the time that tariffs are filed. Under the Rule, as stated by the Commission in Inter-State Water Company, Docket 94-0270, Order at 12 (Apr. 21, 1995):

> . . . the Commission's consistent approach to historical test years has been to include in rate base those projects which are expected to be in service at or about the date of the rate order.

The Company notes that the Adjustment Rule does not require absolute certainty. Instead, the Rule makes reference to "estimated or calculated" items and to items which are "reasonably certain to occur." The Commission confirmed in Inter-State Water Company, Docket 85-0166, Order at 3 (Feb. 26, 1986), that:

> [n]either Part 285.150 nor the Order in Docket 85-0056 indicate that pro forma adjustments should be disallowed merely because they are based on something less than absolute certainty . . . . Rather, adjustments should be allowed where they reflect significant changes reasonably anticipated to occur.

The Company maintains that the evidence amply demonstrates that the plant items which are the subject of Mr. Griffy's adjustment are prudent, appropriate and reasonably certain to be in-service prior to June 30, 1998.

3. Staff Position

In support of the proposed adjustments, Staff witness Griffy suggested that the plant additions at issue are not "known and measurable." He indicates that, at the time of his review in January, 1998, the amounts which are the subject of his adjustments were not supported by "written contracts, purchase orders, job orders or invoices..." He maintains that items supported solely by capital authorizations are not "known and measurable" and therefore should be disallowed. He argues that while capital authorizations represent funds that the Company has set aside for completion of plant addition projects, they are not sufficient proof of actual project expenditures because the completion costs may total more or less than the amount authorized.

He also argued that this type of plant addition expenditure evidence needs to be presented "early enough in the process for Staff to have ample time to review it . . . ." In this regard, Staff makes references to the Order in Consumers Illinois Water Company, Dockets 93-0253/93-0303 (Cons.). In that Order the Commission disallowed costs for which a contract was presented three days prior to the hearings out of an express concern for ensuring fairness in the proceedings.

4. Company Response

The Company maintains that the Order in Dockets 93-0253 and 93-0303 is inapposite. In that proceeding, a new project not contemplated at the time of the utility's direct case (or scheduled update) came to light during the course of the proceeding. CIWC notes that cost of the project was in and of itself several times higher than the entire amount of the utility's initially proposed plant-in-service adjustment. Moreover, CIWC notes that, in language omitted by Staff from the quotation of the Order set forth in its Brief, the Commission noted that the cost of the new project "fluctuated widely" during the course of the proceeding. In light of this, the Commission in other language which Staff omits indicates that Staff and interested parties in that proceeding did not have an adequate opportunity to review the proposed adjustment and prepare their case.

The Company maintains that the situation in this proceeding is nothing like that in Dockets 93-0253/93-0303. CIWC notes that, in this case: (i) the project at issue was fully described in evidence submitted in accordance with the established schedule; (ii) the cost of the project is a component of the plant-in-service adjustment proposed in accordance with the schedule; (iii) there has been no cost fluctuation; and (iv) accurate information regarding the project, including cost data and a copy of the purchase contract, were provided to Staff prior to its review. Moreover, the Company indicates that, in this case, Staff does not describe any hardship or problem of any kind which resulted from the fact that the final signed contract (which merely confirmed exactly what the prior evidence indicated) was available shortly after Staff's review.

5. Commission Conclusion

The Commission concludes that Staff's proposed adjustments to reduce the levels of the plant-in-service adjustments proposed by the Company for the Vermilion County and Oak Run Divisions should be rejected. The evidence demonstrates a reasonable certainty that plant additions at least in the amount proposed by the Company will be complete and in-service at or about the time of the Commission's Order in this case, and within 12 months of the date on which the proposed rates were filed. For the reasons given by CIWC, the Commission concludes that in the Order in Dockets 92-0253/ 93-0303 is inapposite to the present case. For these reasons, the levels of plant additions proposed by CIWC for the Vermilion County and Oak Run Divisions should be reflected in rates.

C. Plant Additions-Related Adjustments

As indicated above, Staff's proposed income statements and rate bases for the Vermilion County and Oak Run Divisions should be modified to reflect the full amount of the plant-in-service adjustments proposed by the Company. In connection with these modifications, the Commission notes that corresponding adjustments also should be made to the levels of depreciation expense, accumulated reserve for depreciation and

accumulated deferred federal and state income tax ("ADIT") reserves, and capitalized incentive compensation. The levels proposed by CIWC for these items are reasonable and should be accepted.

D. Cash Working Capital and Accrued Real Estate Taxes

1. Positions of the Parties

The Company and Staff agreed on the method of calculating each Division's allowance for cash working capital. Both used the "one-eighth" formula method, under which the total pro forma level of operating expense (as adjusted to remove certain non-cash items, rate case expense, and real estate tax expense) is multiplied by one-eighth, representing a 45-day lag between the time that expenses are incurred and the time that revenues to cover those expenses are received. The difference between their positions regarding the amount of each Division's cash working allowance was attributable only to differences in the levels of operation and maintenance ("O&M") expense.

Danville witness Smith proposed an adjustment to deduct the test year average balance of Accrued Real Estate Taxes, in the amount of $197,207, from the Vermilion County Division's rate base. In support of his proposal, he asserted that these taxes represent a liability that is "funded" by ratepayers. Danville argued that the Company and Staff approach of deducting real estate tax expense from the test year level of O&M expense to which the cash working capital formula is applied fails to give ratepayers adequate "credit for the amount of funds they are providing to the Company in advance of the Company's payment of such real estate tax expense".

In response to Danville's proposed adjustment, Mr. Maurer testified that the balance of Accrued Real Estate Taxes at any point in time represents the balance of real estate taxes which have been accrued as an expense, but which have not yet been paid to the taxing authority, at that time. He also testified that real estate taxes are paid in the year following the year in which the liability for such taxes is incurred. Accordingly, there is no cash working capital requirement associated with such taxes. For this reason, as indicated above, both the Company and Staff subtracted the full amount of the pro forma test year level of real estate tax expense from the level of test year O&M expenses to which the cash working capital formula is applied.

Mr. Maurer testified that such an approach (i) gives full recognition to the fact that real estate taxes are paid in arrears and (ii) was approved by the Commission in the most recent rate case involving CIWC, Docket 95-0641 and in the case of Inter-State Water Company, Docket 94-0270. Mr. Maurer also testified that Danville's proposal to subtract the entire test-year average balance of Accrued Real Estate Taxes from rate base is inconsistent with the use of the one-eighth formula method for calculating cash working capital and, as a result, understates the Company's cash

working capital requirements. For these reasons, the Company asserts that Mr. Smith's proposed rate base adjustment is inappropriate and unnecessary.

2. Commission Conclusion

The Commission concludes that Danville's proposal to deduct the test year balance of Accrued Real Estate Taxes from the Vermilion County Division rate base should be rejected. The evidence shows that the Company and Staff approach of deducting the test- year level of real estate tax expense from the test year level of expenses to which the "one-eighth" cash working capital formula is applied gives ratepayers credit for the fact that these taxes are paid in arrears. The evidence also shows that Danville's proposal to subtract the entire test-year balance of Accrued Real Estate Tax Expense is inconsistent with the use of the one-eighth formula and would, if adopted, understate CIWC's cash working capital requirement. In this regard, the Commission agrees that, if Danville's proposal were to be adopted, consistency would require that offsetting rate base adjustments be made to recognize the cash working capital requirements with respect to items such as prepayments, unamortized rate case expense and interest payments. Based on the evidence, the Commission finds that the approach proposed by the Company and Staff, which was approved in Docket 95-0641, is more consistent with the purpose of the formula method than the approach proposed by the City.

E. FAS 106 Accruals

1. Positions of the Parties

FAS 106 requires the Company to reflect on its books an annual accrual of costs associated with its future obligation to provide post-retirement benefits other than pensions. The Company implemented FAS 106 on January 1, 1993. In accordance with Commission policy, the pro forma test-year level of operating expenses for each Division, as proposed by both the Company and Staff, includes an allowance for that Division's allocable share of CIWC's 1997 FAS 106 expense accrual, developed on the basis of an actuarial study.

In his direct testimony, Danville witness Smith proposed an adjustment to deduct from the Vermilion County Division's rate base an amount which, he claimed, represents "unfunded" FAS 106 accrual amounts (net of associated ADIT) accumulated from 1993 through June 30, 1998. At the hearing held on February 4, 1998, he presented a revised adjustment of $97,269 which, he claimed, was calculated to exclude amounts improperly included in his original adjustment, i.e., amounts accrued prior to April 25, 1995, when rates reflecting recovery of FAS 106 costs became effective in Docket 94-0270. In support of his position that a rate base deduction should be made, Mr. Smith argued that the Company and Staff approach will deprive ratepayers of rate base benefits/deductions to which they would have been entitled if a funding approach had been utilized in the Company's last rate case.

In response to Danville's proposed adjustment, the Company pointed out that the Commission has consistently recognized that no rate base deduction for FAS 106 accruals is appropriate for a utility which has established a vehicle to fund such accruals. Central Illinois Public Service Company, Docket 91-0193 at 61-63 (March 18, 1992); Illinois-American Water Company, Docket 92-0116 at 4-5 (Feb. 9, 1993). Mr. Maurer testified that, effective July 1, 1997, Consumers Water Company ("Consumers") and its affiliated companies (including CIWC) entered into a Voluntary Employees' Beneficiary Association (VEBA) Trust Agreement with Fleet Bank of Maine, as a means of funding FAS 106 accruals. He also testified that the full amount of the 1997 FAS 106 accrual was funded in December 1997 and that the entire amount of CIWC's FAS 106 liabilities, reflecting expense accruals, net of payouts, since 1993, will be funded through the VEBA trust in accordance with IRS requirements. The Company indicated that, for this reason, the rate bases proposed by the Company and Staff reflect no deduction for FAS 106 costs. Thus, the Company contends that Danville's proposed adjustment calculation which is based on the erroneous assumption that no funding of FAS 106 accruals has occurred, or will occur is unfounded.

Mr. Maurer testified that the calculation of Danville's proposed adjustment also is flawed because: (i) it was based on annual accrual amounts which exceed the amount of the annual FAS 106 expense accrual actually allowed in the last rate case for the Vermilion County Division, Docket 94-0270 and (ii) failed to properly reflect an offsetting ADIT adjustment. The Company contends that ratepayers have not been "deprived" of any benefits to which they are entitled. CIWC also asserts that all of its FAS 106 accruals "that have occurred since the last case" either have been, or will be, funded through the VEBA trust. Accordingly, such accruals do not represent a source of "ratepayer-supplied capital" and ratepayers are not entitled to the benefit of a rate base deduction for purposes of establishing rates in this case. The Company also contended that Danville's suggestion that a rate base deduction should be made in order to compensate ratepayers for benefits of which they were allegedly "deprived" in the past violates the rule against retroactive ratemaking.

2. Commission Conclusion

The Commission finds that Danville's proposed adjustment to deduct FAS 106 accrual amounts from rate base in the Vermilion County Division is unsupported by the evidence and should be rejected. Danville's proposal is based on the assumption that the FAS 106 accruals it seeks to deduct are "unfunded." As the evidence summarized above demonstrates, this assumption is wrong. The Company has established a VEBA trust to fund all FAS 106 accruals. The full amount of the 1997 accrual was funded in December 1997. In accordance with IRS regulations, the entire amount of CIWC's FAS 106 liability accrued since 1993 will be funded through the VEBA trust. These facts were not disputed in the record. Consistent with well-established Commission policy, therefore, no rate base deduction should be made for FAS 106 costs. The evidence also shows that the calculation of Danville's proposed adjustment is in error because it (i) erroneously assumed that no funding of FAS 106 accruals through June 30, 1998

has occurred; (ii) is based on annual accrual amounts which exceed the amount of the annual FAS 106 expense accrual allowed in the rates approved in Docket 94-0270; and (iii) fails to reflect an appropriate offsetting ADIT adjustment. For the reasons discussed by the Company, the Commission concludes that there is no basis for Danville's arguments.

F. Deferred Income Taxes-AMT

1. Positions of the Parties

CIWC made an adjustment to reduce the Vermilion County Division's test-year ADIT balance by $34,848, to reflect an allocation of the 1991, 1993 and 1994 accrued AMT to that Division. Mr. Maurer testified that this adjustment is appropriate because it reflects a net increase in current federal income tax liability incurred as a result of a reduction in asset-based tax depreciation allowed in determining AMT taxable income. This increased liability is the result of a timing difference which is reflected on the Company's books in a deferred debit tax account and properly added back to rate base (as are deferred debit taxes on CIAC recorded within the same general ledger account sequence) pursuant to the 83 Ill. Adm. Code 605, Uniform System of Accounts for Water Utilities.

Danville witness Smith proposed that the Company's ADIT adjustment for AMT in the Vermilion County Division be disallowed. In support of his position, he suggested that CIWC's adjustment is "inappropriate for ratemaking" because the debit balance of AMT "has not previously been included in rate base for the Vermilion County Division". In response, Mr. Maurer testified that the AMT tax liability amount was not included in prior rate filings involving the Vermilion County Division due to an oversight. The Commission, however, has allowed the AMT tax liability as a rate base adjustment in CIWC's two most recent rate cases, Dockets 95-0307/95-0342 and Docket 95-0641.

Mr. Smith also asserted that, because the AMT amounts reflected in the Company's adjustment relate to years prior to the 1995 merger of CIWC and Inter-State Water Company ("Interstate") (which became the Vermilion County Division), "none of this pre-merger AMT applies to the Vermilion County Division". In response, the Company states that the 1995 merger of Interstate and CIWC into a single subsidiary has no bearing whatsoever on the appropriateness of the Company's proposed adjustment.

2. Commission Conclusion

The Commission finds that the Company's adjustment to reduce the Vermilion County Division test year balance of ADIT by $34,848 to reflect accrued AMT is supported by the evidence and should be approved. The evidence shows that from 1990 to 1994, Interstate (which become Vermilion County Division from the 1995

merger with CIWC) incurred a net AMT liability of $37,068, an amount greater than the amount of AMT allocated to the Vermilion County Division in this filing. The Commission finds that CIWC's adjustment is appropriate for ratemaking purposes. The evidence shows that the adjustment is necessary its reflect a net increase in the Company's current federal income tax liability as a result of reduction in asset-based depreciation in determining AMT taxable income. The Commission approved similar adjustments in CIWC's last two rate cases, Dockets 95-0307/95-0342 (Kankakee and University Park-Sewer Divisions) and Docket 95-0641 (Candlewick Sewer Division). Danville has not identified a valid basis for treating the accrued AMT allocable to the Vermilion County Division differently than the accrued AMT allocable to the Company's other operating Divisions.

V. OPERATING EXPENSES AND INCOME

A. Introduction

The Company selected an historical test year ending December 31, 1996, with adjustments to reflect significant changes to operating expenses which have occurred or are reasonably certain to occur through June 30, 1998 for each Division. During the course of the proceeding, Staff proposed a number of adjustments to the Company's test- year operating income statements. CIWC has accepted certain of Staff's proposed adjustments. In addition, Staff has withdrawn certain of its proposed adjustments and modified others in response to evidence presented by CIWC. As a result, the following items of the operating income statement are no longer in dispute between the Company and Staff: wages and salaries; health insurance expense; bad debt expense; accounting expense; advertising expense; property and liability insurance expense; dues expense; charitable contributions; employment taxes; tank painting expense; lease expense; and gross revenue conversion factor.

The only issues involving the operating income statements that remain in dispute between the Company and Staff are those related to Staff's proposals to (i) disallow test year incentive compensation expense, early retirement expense and relocation expense; (ii) disallow the Company's adjustment to reflect increases in real estate tax expense accruals during 1997; (iii) use a four-year, rather than a three-year, amortization period for rate case expense in the Kankakee Division; and (iv) disallow depreciation expense on certain plant additions in the Vermilion County and Oak Run Divisions.

In this proceeding, the Company accepted certain adjustments proposed by Mr. Smith, which duplicated adjustments proposed by Staff. CIWC also accepted his proposed adjustment to early retirement expense to reflect a three-year amortization period. The operating income statement issues which remain in dispute between the Company and Danville involve the latter's proposals to (i) disallow CIWC's proposed adjustment for an increase in the Vermilion County Division's real estate tax expense accrual during 1997; (ii) reduce the allowed amount of relocation expense in the

Vermilion County Division; (iii) disallow the Vermilion County Division's test year levels of incentive compensation expense and Total Quality Management ("TQM") employee training costs; (iv) disallow depreciation expense associated with a main extension project; (v) disallow a portion of the actual 1997 wage and salary increases in the Vermilion County Division; and (vi) disallow the labor and labor-related expenses associated with certain employees in the Vermilion County Division.

The Commission has been very thorough in its consideration of the position of the parties concerning the disputed operating expenses and income adjustments. The conclusions reached by the Commission on these matters are a result of its careful review of the entire record, including the exceptions filed by the parties. Only those changes regarding Incentive Compensation are required as a result of reviewing the exceptions.

B. Incentive Compensation Expense

1. Positions of the Parties

The Company offers an incentive compensation plan to each non-union employee and for union employees whose contract calls for application of the plan. The purpose of the program is to promote cost reduction, maximize efficiency, and improve performance. The Company's incentive compensation plan is based upon the achievement of three pre-established goals or performance measures. The goals are assigned a weighting or a percentage which is applied to the budgeted incentive compensation expense in order to determine the amount of the award. The three goals or performance measures and assigned weighting are: 1) team goals, 40%; 2) corporate earnings, 20%; and 30 local earnings, 40%. The Company is seeking incentive compensation related to its team goals and corporate earnings components; it is not seeking recovery related to the third component, local earnings. According to a Company witness, this proposal is consistent with the incentive compensation plan approved by the Commission for Illinois-American Water Company in Docket 97-0102.

For 1997, the Company anticipates that employees will receive $72,000 in incentive compensation based on 100% achievement of the operational and performance team targets and parent company financial performance goal. Of this amount, $57,000 is anticipated to be expensed and $14,400 capitalized. The pro forma level of incentive compensation expense for each Division reflects that Division's allocable share of the 1997 expense level of $57,000. This amount does not include costs for that component of the incentive compensation plan related to meeting CIWC's financial performance goal. Furthermore, because this rate case involves only five of the Company's eleven operating divisions, the total amount of pro forma incentive compensation expense proposed for allowance in this case is $44,929.

Mr. Maurer testified that, based on past experience, there is a high degree of certainty that the proposed incentive compensation levels actually will be paid. He

stated that the Company implemented the current incentive compensation program in 1995 and incurred expenses of $86,478 and $44,635 in 1995 and 1996, respectively. CIWC also incurred incentive compensation expense under the prior program in 1994. Actual 1997 data indicate that the parent company's earnings will exceed the 1997 corporate earnings target by approximately $.03 per share. Mr. Maurer also opined that the Company is likely to achieve 100% of the 1997 operational and performance target component. CIWC, therefore, contends that its proposed allowance for incentive compensation expense is fully supported by the record.

Staff witness Knepler argued that incentive compensation costs (including those associated with the team goals) should be disallowed in their entirety. In support of his position, he argued that the Company failed to support its proposed adjustment for incentive compensation expense. Mr. Knepler also objected to the inclusion of the team targets because he argued that they lack merit. Staff contended that an incentive compensation plan should contribute directly to customer service, water quality, service reliability and customer inquiries, Furthermore, Staff argued that at least 6 of the 17 team targets are dedicated to financial success of Consumers, not to cost reductions nor to efforts to maximize efficiency or improve performance. When these 6 financially oriented team targets are combined with the remaining two components of the Consumers incentive compensation plan (i.e. the 20% Corporate Earnings and 40% Local Earnings performance measures), the result is a plan which is skewed toward financial performance, not operational efficiencies. Staff also argued that the scoring of team targets is results-oriented.

In response, Mr. Maurer testified that achievement of those targets is anticipated to deliver cost savings ideas and information, and lead to improvements in service, which will benefit both the Company and its customers. CIWC contends that the criticisms regarding the team targets are unfounded and represent an inappropriate attempt by Staff and Danville to substitute their judgment for that of CIWC's management regarding the appropriate means of setting employee compensation. Mr. Maurer also testified that, while it is conceivable that, in any given year, the amount of incentive compensation cost may be above or below the amount reflected in rates in a rate proceeding, this does not mean that such costs should be disregarded for ratemaking purposes.

Staff witness Knepler opposed the recovery of incentive compensation expense related to the earnings because it is an inappropriate component. The recovery of incentive compensation related to the corporate earnings goal relies on circular reasoning; i.e., the larger the rate increase granted, the more success CIWC will have in achieving its earnings goals, and thus, enhance its ability to award incentive compensation. Furthermore, as in the case of CIWC's incentive plan, where "local earnings" contribute directly to "corporate earnings," there is no logical reason why one earnings factor should be included and the other excluded. Although the Company is not requesting recovery related to the local earnings factor, the impact cannot be considered in isolation because local earnings contribute directly to corporate earnings.

Staff argued that an incentive compensation plan should contribute directly to customer service, water quality, service reliability, and customer inquiries. Furthermore, the success of at least 6 "team goals" is primarily dedicated to the financial success of the Company (not customer service, water quality, service reliability, and customer inquiries). Certain "team goals" contribute directly to the corporate earnings component; local earnings contribute directly to the corporate earnings component; all of which contribute to the success of CIWC's incentive compensation program. The common thread running through the three incentive compensation program factors is the financial success of the Company. The earnings component of CIWC incentive compensation plan is an inappropriate component and should be denied recovery.

Mr. Smith proposed disallowing incentive compensation expense for the Vermilion County Division on the grounds that such expense represents payments made to employees "in excess of normal salaries." He also asserted that "benefits generated by any improved efficiencies that lead to bonuses would flow to shareholders during the period between rate cases." Mr. Smith also argued that the Commission has previously "disallowed CIWC's incentive compensation expense."

In response to Mr. Smith's arguments, the Company notes that in Dockets 95-0307/95-0342, CIWC proposed to include in rates amounts which reflected a three-year amortization of the level of costs which it projected it would incur in 1995, the first year of the current incentive compensation program, for the Kankakee Water and University Park-Sewer Divisions. In its Order in that case, the Commission concluded that the proposed level of incentive compensation expense should be disallowed in light of the "uncertainty of annual expense" and "lack of payment history." Order at 25. As previously discussed, however, the Company now has a "payment history" under its current incentive compensation program. CIWC asserts that the proposed level of incentive compensation expense in this proceeding is supported by its historical pattern of paying incentive compensation costs, the likelihood that the incentive compensation goals will be achieved, and the nature of the ratepayer benefits which will accrue as those goals are achieved.

2. Commission Conclusion

The Commission finds that the allowance for incentive compensation expenses proposed by the Company in this case is fully supported by the evidence and should be approved. The evidence summarized above demonstrates that CIWC's proposed allowance for incentive compensation expense is consistent with the Commission Order in Illinois-American, Docket 97-0102 and with the Commission's decision in NI-Gas, Docket 95-0219. The evidence shows that the level of incentive compensation expense proposed in this proceedings is supported by CIWC's historical pattern of paying incentive compensation costs, the likelihood that the incentive compensation goals will be achieved and the nature of the ratepayer benefits which will accrue as those goals are achieved.

A portion of the normal compensation for each employee covered by the incentive compensation plan is tied directly to the achievement of goals which are designed to lead to improvements in service, as well as to cost savings. Accordingly, ratepayers can only benefit from the incentive compensation program.

The evidence shows that compensation provided to CIWC employees (including incentive compensation) is reasonable and in accord with prevailing standards in the water industry and in the communities in which CIWC operates. There is nothing in the record that would reasonably suggest that the Company's management of the incentive compensation program, or the costs incurred for that program, are in any way imprudent. Accordingly, CIWC's proposed allowance for incentive compensation expense should be allowed in full. In this Order, Staff's allowances for incentive compensation, for simplicity, merely have been reversed, even though Staff had to adjust against Salaries and Wages for some Divisions and against Employee Benefits for other Divisions. Corresponding additions to plant additions and depreciation expense stem from the portions of the incentive compensation to be capitalized.

C. Early Retirement Expense

1. Position of the Parties

In 1996, CIWC incurred costs (pension annuity and health insurance premium) associated with the early retirement of its former President, Charles H. Smith. The Company proposes to recover $33,000 of the total early retirement expense, over a three-year amortization period, from the five Divisions included in this proceeding. CIWC contends that its proposal is supported by past Commission Orders which recognize that early retirement costs are a normal operating expense and should, therefore, be recoverable through rates. Commonwealth Edison, Docket 94-0065 (Jan. 9, 1995), Illinois Power, Docket 89-0276, Order at 120-21 (June 6, 1990), and Illinois Power, Docket 91-0147 (Feb. 11, 1992).

Mr. Maurer testified that in connection with Mr. Smith's early retirement, the Company arranged for his availability to consult with present management on matters where his knowledge and experience will be helpful. He opined that the Company and its customers will benefit from Mr. Smith's availability in this regard. Mr. Maurer also testified that the ability to provide early retirement benefits in appropriate circumstances such as this is an important tool in retaining and maintaining a quality work force.

Mr. Knepler proposed that the expense be disallowed, arguing that this is a non-recurring operating expense of the Company, and as such it does not result in any benefits to ratepayers which is recognizable for recovery by the Company. Moreover, he argued that recovery of this expense would in fact result in detriment to the ratepayers as the early retirement expense duplicates the current President's salary and benefits resulting in double billing to the ratepayers without corresponding

benefits. He asserted that the decisions in Commonwealth Edison and Illinois Power are distinguishable from this case. In those cases, the Commission approved the early retirement expense due to the fact that the early retirement produced a permanent reduction in workforce. Staff has argued that no permanent workforce reduction has occurred from the early retirement of Charles Smith in this case.

Mr. Maurer testified, and Mr. Knepler acknowledged, that the pro forma test-year level of compensation for the current President is $16,692 less than the 1996 salary of the now retired President. However, the Staff argues that this reason alone should neither preclude ratepayers from enjoying and receiving the benefit of this salary reduction, nor mandate recovery by the Company.

2. Commission Conclusion

The Commission finds that the Company's proposal to recover the expense associated with the early retirement of its former President, Mr. Charles H. Smith, should be disallowed. We reject its argument that the recovery of this expense is fully supported by the record and by the past Commission orders which allowed recovery of early retirement costs. Commonwealth Edison, Docket 94-0065 (January 9, 1995); Illinois Power, Docket 89-0276, Order at 120-21 (June 6, 1990); Illinois Power, Docket 91-0147 (February 11, 1992). Staff has correctly distinguished those decisions, and correctly argued that the early retirement expense at issue in this case duplicates the salary and benefits of the Company's current President.

D. Relocation Expense

1. Positions of the Parties

During 1996, the Company incurred $49,000 of costs in connection with the relocation of its new President, Mr. Rakocy, to the Kankakee area. CIWC proposes that each Division's allocable share of this cost be amortized over a three-year period. It noted that the proposed adjustment is supported by Interstate, Docket 94-0270, Order at 20-21, in which the Commission allowed recovery of post-test year relocation costs for a new operations manager in the Vermilion County Division over a three-year amortization period.

Staff witness Fullington proposed that the relocation expense be disallowed on the grounds that this is not a recurring expense. He argued that there was not sufficient evidence in the record to substantiate that this was a normal operating expense. Furthermore, he proposed that the relocation expense be disallowed on the grounds that this is not a test year expense, as it was incurred in 1997. He also argued that there was no evidence to show that this expense was known or incurred in the 1996 test year.

In response, Mr. Maurer testified that relocation expense is regularly incurred by the Company in connection with various employees, not just the President. Mr. Maurer also noted that the Company properly accrued the relocation expense in 1996. He stated that under Financial Accounting Standards Board Statement No. 5 ("FASB 5"), an expense which is not directly related to operations or sales in a particular year must be accrued in the year in which it becomes known, irrespective of when cash payments related to the expense are made. He suggested that since, in this case, the fact that Mr. Rakocy would relocate to Kankakee as the Company's new President became known in 1996, it was also known in that year that CIWC would be required to incur relocation costs. For this reason, the Company argues that the relocation costs were properly recorded as an expense in 1996.

In response to this argument, the Staff contends that CIWC's relocation expense liability which could be recognized under FASB would not have occurred until the services were rendered in 1997, given the definition of the word "liability" in the Statement of Financial Accounting Concepts No. 6. Staff points out that under this definition, a liability is a present obligation for a future economic sacrifice resulting from a past transaction or event. Staff argues that the event triggering the obligation must have occurred in order for the liability to be incurred, and in this case the liability did not occur until the relocation had taken place.

The Company also points out that even if the relocation expense is viewed as an "out -of- period" expense, the proposed amortization remains appropriate because the Adjustment Rule permits pro forma adjustments for "all known and measurable changes in the operating results of the test year," including changes "reasonably certain to occur subsequent to the selected test year within 12 months from the filing of the tariffs." The Staff contends that the Company's reliance on the Adjustment Rule is unfounded since this rule explicitly requires that the "known and measurable" change be incurred in the test year. Staff argues that there was no evidence in the record to show that this adjustment occurred in 1996 nor was known and measurable in 1996.

Mr. Fullington proposed that, if the Commission allows recovery of relocation expense, the expense should be amortized according to the amortization period approved for rate case expense in each Division. In opposing this proposal, Mr. Maurer testified that rate case expense should be amortized over the expected life of the rates established in a proceeding. Relocation expense, on the other hand, should be amortized over a period which is representative of the frequency of occurrence of that expense. Mr. Maurer opined that three years is a reasonable amortization period for relocation expense.

Danville witness Smith proposed an adjustment to reduce the amount of relocation expense allocated to the Vermilion County Division by $3,839, based on his assumption that the total amount being amortized includes a "bridge loan" of $50,500. In response, Mr. Maurer testified that the bridge loan was repaid by Mr. Rakocy in March 1997, and the relocation expense accrual was reduced at that time to reflect only

appropriate relocation items, such as moving and travel costs. Accordingly, he indicated that the amount which the Company proposes to amortize does not reflect the "bridge loan".

Mr. Smith also proposed that, if any amount greater than $8,876 is included in allowed relocation expense, the amortization period should be 15 years based on the projected retirement date of the Company's new President. In response, Mr. Maurer testified that the three-year amortization period proposed by the Company in this case is (i) representative of the expected frequency of this type of expense and (ii) consistent with the Order in Docket 94-0270, in which the relocation costs incurred by the Vermilion County Division were allowed in rates through a three year amortization adjustment.

2. Commission Conclusion

The Commission concludes that Staff's proposal to disallow the relocation expense at issue in this case on the grounds that relocation expenses are "non-recurring " and that they were incurred outside of the test-year period should be rejected. The Staff's argument that this expense should be disallowed because it is incurred on an irregular basis is directly contrary to our decision regarding relocation expense in Docket 94-0270. Staff's argument that the relocation expense should be disallowed because it was not incurred until 1997 must also be rejected. The Commission finds that the Company's adjustment to reflect the amortization of relocation expense would be appropriate under the Adjustment Rule even if it were deemed to be an "out-of-period" expense. As discussed above, for example, the Commission approved such an adjustment in Docket 94-0270.

The Commission also rejects Danville's argument that a portion of the relocation expense should be disallowed because it represents a "bridge loan". The evidence shows that the "bridge loan" and the relocation expense accrual were two separate transactions and that the amount which the Company proposes to amortize does not include the "bridge loan".

Finally, the Commission rejects the Company's proposal of a three-year amortization period for the relocation expense. The Commission agrees with the Staff and Danville that the amortization period for the relocation expense should extend beyond three years. We find that a five-year amortization period is reasonable.

E. Real Estate Tax Expense

1. Positions of the Parties

The Company developed its pro forma test-year level of real estate tax expense for all Divisions other than Woodhaven by applying the actual average percentage increase for the past five years to the actual 1996 tax bills to determine the appropriate

accrual for the 1997 bills (payable in 1998). Because the Woodhaven Division has experienced abnormally high fluctuations in its real estate tax bills over the past five years, that Division's 1997 real estate tax accrual was calculated by applying the one-year increase from 1995 to 1996 to the 1996 tax bill.

Mr. Fullington proposed that the allowed level of real estate tax expense for each Division be limited to the amount of the 1996 bill, without any adjustment to reflect an increase in real estate expense accruals for 1997. He asserted that such an adjustment is not "known and measurable," relying on his interpretation of the Adjustment Rule. Similarly, Mr. Smith asserted that no adjustment should be made to reflect an increase in the Vermilion County Division's real estate tax expense for 1997 because "property taxes do not necessarily increase in every year . . . ." He revealed that, for the Vermilion County Division, the Company's workpapers show that real estate taxes decreased from 1992 to 1993.

In response to the positions of Staff and Danville, CIWC notes that it has calculated its adjustment based on the five-year average of actual changes in real estate tax expense. Mr. Cummings testified that the actual data support its position that an increase in 1997 real estate tax expense over the 1996 expense is reasonably certain to occur. With regard to Mr. Smith's assertion regarding the 1993 decrease in the Vermilion County Division's real estate tax expense, CIWC notes that the decrease in that year was only $1,208, or 0.6% of the 1992 expense. In each of the years 1992, 1994 and 1995, the Vermilion County Division's real estate tax expense increased by approximately 7.0%.

2. Commission Conclusion

The Commission finds that the proposed adjustments for increases in real estate tax accruals are consistent with the Adjustment Rule, supported by the evidence and should be approved. As the Commission has confirmed, the Adjustment Rule does not "indicate that pro forma adjustments should be disallowed because they are based on something less than absolute certainty. Rather, adjustments should be allowed where they reflect significant changes reasonably anticipated to occur." (Interstate, Docket 85-0166, Order at 3). In accordance with the Adjustment Rule, the proposed adjustments are based on a particularized study of the five-year average of actual changes in real estate tax expense for each Division. For the reasons discussed above, the Adjustment Rule cannot reasonably be construed to preclude a utility from developing a pro forma adjustment to an individual expense item based on a particularized study of actual historical changes in that expense item. The evidence shows that increases in 1997 real estate tax expense over the 1996 expense are reasonably certain to occur and that the proposed adjustments reflect a normal level of change for this item. For this reason, the adjustments proposed by CIWC are approved.

F. Rate Case Expense Amortization

1. Positions of the Parties

The only contested issue involving rate case expense concerns the amortization period for the Kankakee Division. It is well established that rate case expenses should be amortized "over the period of time that the subject tariffs are reasonably anticipated to be in effect." Illinois Bell Telephone Company, Docket 89-0033, Order at 78 (Nov. 9, 1989). Consistent with this principle, CIWC proposed to amortize rate case expense for the Kankakee Division over three years. In support of this proposal, Mr. Maurer testified that under the Company's Business Plan for 1998-2000, the Kankakee Division's next rate case is expected to be filed in the year 1999, with the result that the rates established for that Division in this case would have a two-year life. CIWC asserts that a three-year amortization period is a conservative estimate of the period of time that the Kankakee Division rates established in this case are reasonably anticipated to be in effect.

Mr. Fullington proposed a four-year amortization period for the Kankakee Division, based on the average period of time between the four rate filings made since 1985. In support of this approach, Staff indicated that it is attempting to match the amortization period of rate case expense more closely to the Company's actual experience. In response, CIWC asserted that the timing of the next Kankakee Division rate case filing will not be based on the average time between past rate case filings going back twelve years. Rather, as Mr. Fullington acknowledged, the timing of the next rate case will be dependent on future changes in operating expenses, revenues, rate base and capital costs. As previously discussed, the next Kankakee Division rate case is expected to be filed in 1999. Mr. Maurer testified that there is no reasonable basis to expect that the rates approved in this case will be in effect for four years.

The Company also contended that Staff's proposal in this case is contrary to the approach proposed by the Staff (and adopted by the Commission) in the last rate case for the Kankakee Division, Dockets 95-0307/95-0342. The Company contends, if the approach proposed by Staff in the those dockets were used to select an amortization period for the Kankakee Division in this case, the proper period would be two years. The Company submits that it is inappropriate for the Staff, in each case, to pick and choose among different methodologies based on different sets of historical data in order to produce a desired result. CIWC asserts that, in contrast to Staff, it has been consistent in its approach.

Mr. Fullington suggested that CIWC would not be harmed by the adoption of an amortization period which is too long because the Company will have the "opportunity to collect any unamortized rate case expense from this rate case in the next rate proceeding." CIWC agrees that, if a four-year amortization period is adopted, full recovery of rate case cost should be allowed in future rate cases. The Company, however, indicates that there are two reasons why Mr. Fullington is incorrect in

suggesting that CIWC and its customers would not be harmed if a four-year amortization period is adopted.

First, Mr. Maurer testified that, as a matter of ratemaking policy, it is appropriate to match, as closely as possible, the level of rate case expense to the life of the rates established. If this is done, it would be unnecessary to carry rate case costs from one case to the next. Second, both the Company and Staff have proposed in this proceeding to exclude unamortized rate case expense from rate base in accordance with recent Commission practice. According to CIWC, therefore, an unduly long amortization period would harm the Company because no return is provided on its investment in the unamortized balance of rate case expense.

2. Commission Conclusion

Based on the evidence, the Commission finds that CIWC's proposal to amortize the Kankakee Division's rate case expense over three years is reasonable and should be approved. The appropriate standard for establishing an amortization period is the time interval that the rates to be determined in this case are expected to be in effect. Illinois Bell, Docket 89-0033, Order at 78. Under the Company's Business Plan for the 1998-2000 period, the Kankakee Division's next rate case is expected to be filed in the year 1999. The three-year amortization period proposed by the Company is, therefore, a conservative estimate of the period of time that the Kankakee Division rates approved in this case are expected to be in effect. Moreover, in the Kankakee Division's last rate filing, CIWC proposed a three-year amortization period based on its 1996-1998 Business Plan, which indicated that a rate filing would be required in 1998. (See Dockets 95-0307/95-0342, Order at 20). The current proceeding was filed two years after the filing of those dockets. Accordingly, CIWC's actual experience also supports its current approach and the conclusion that three years is a reasonable and conservative estimate of the life of the rates to be approved in this case. Staff cites no evidence which indicates that there is a reasonable basis to expect that the rates approved in this case will be in effect for four years.

The Commission disagrees with Staff's contention that the Company and its ratepayers will not be harmed by the adoption of an amortization period which is too long. As previously discussed, the Commission finds no reasonable basis to expect that the rates approved in this case will be in effect for a period of time longer than three years. Adoption of Staff's proposed four-year amortization period would increase the possibility that the rates approved in the Kankakee Division's next rate case will have to be adjusted to reflect recovery of expenses from two past cases (Dockets 95-0307/95-0342 and this case), in addition to the expenses associated with the next case. The evidence also shows that an unduly long amortization period, such as that proposed by Staff, will harm the Company because it has no opportunity to recover the carrying costs associated with its investment in the unamortized balance of rate case expense.

G. Depreciation Expense

The Company and Staff agree on the pro forma test year levels of depreciation expense for the Kankakee, University Park-Water and Woodhaven-Sewer Divisions. The differences between their proposed levels of depreciation expense for the Vermilion County and Oak Run Divisions are attributable solely to the differences between their positions with respect to adjustments for plant additions in those two Divisions. As discussed previously in this Order, the Commission finds that the Company's proposed adjustments for plant additions should be approved in full. Accordingly, we find that the Company's proposed levels of the depreciation expense also should be approved.

Mr. Smith proposed an adjustment to reduce pro forma depreciation expense in the Vermilion County Division by $17,142, based on his position that the cost of a main extension (the "Alcoa Extension"), which is being constructed by the City should be classified as a Contribution-In-Aid-of Construction ("CIAC"), rather than as a Customer Advance. At the hearing held on February 4, 1998, he testified that Danville proposes to retain ownership of the Alcoa Extension and lease it to CIWC. The City argued in its Initial Brief that this "arrangement would also not result in any need for the Company to refund construction costs to the City, and would eliminate the need to charge ratepayers for depreciation."

CIWC objected to Danville's proposed adjustment, pointing out that the City and the Company have not agreed on the terms of a lease agreement. CIWC also noted that the purpose of the main is to enable it to extend service to new customers. To do so, the Company must comply with the terms of the Commission's rule governing main extensions, which provides that "unless other terms and conditions are formally approved by the Commission," CIWC is required to make refunds to Danville in a total amount up to the cost of the extension over ten years. 83 Ill. Adm. Code 600.230. Mr. Cummings and Mr. Griffy argued that, unless and until such approval is obtained, the Alcoa Main Extension should continue to be treated as a Customer Advance, and depreciation on the extension should be allowed for ratemaking purposes.

Based on the evidence, the Commission concurs with the Company and Staff that the Alcoa Main Extension should be treated as a Customer Advance. Unless and until the parties agree to an arrangement which varies from the requirements of 83 Ill. Adm. Code 600.370, and obtain our approval for such variance, CIWC will be required to make refunds to Danville in accordance with the requirements of main extension deposit rule. There is no dispute that depreciation expense should be allowed on the property which is treated as a Customer Advance. Similarly, capitalized incentive compensation is depreciable.